Broke

BY
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The mortgage industry's approach to consumer-protection compliance needs fixing.

"Although the high rate of delinquency has a number of causes, it seems clear that unfair or deceptive acts and practices by lenders resulted in the extention of many loans, particularly high-cost loans, that were inappropriate for or misled the borrower."
—Federal Reserve Chairman Ben Bernanke

Until recently, compliance with consumer-protection regulations sounded like an arcane and achingly dull topic. Yet the recent surge in regulation and enforcement activity has made the subject hugely important. And the staggering size and scope of damages expected in pending lawsuits are anything but dull. /// Curiously, for all its troubles, the industry is overspending on its compliance programs. That is because its approach to managing compliance is, arguably, no longer relevant. This article explains why the industry's way of handling compliance risk is broken, who is making sure it gets fixed and how best to go about doing so.

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Black clouds

But first, what is the scope of the problem?

The mortgage industry is struggling to comply with consumer-protection laws. A remarkable report published by the inspector general of the Federal Deposit Insurance Corporation (FDIC) reveals that 83 percent of federally supervised banks that made loans at the peak of the mortgage boom were cited for patterns of "significant compliance violations" (FDIC Report No. 06-024, September 2006).

The percentage is presumably higher for state-licensed, nondepository lenders that were responsible for originating 52 percent of subprime mortgages and are subject to a much broader patchwork of state regulation (source: Federal Reserve Board, based on Home Mortgage Disclosure Act [HMDA] data).

But if regulatory non-compliance is so rife, why haven't regulatory fines and private damages been more prevalent and substantial?

The answer—or at least part of it—is that the industry and its customers had little to fuss over while housing prices rose and financing options abounded. Further, consumer protection was largely in the hands of regulators that lacked the resources and clout to effectively deal with what has become an extremely complex industry.

Consider that the FDIC report also revealed that 85 percent of institutions found to have a multi-year pattern of "repeat, significant violations" were rated by the FDIC as having strong or generally strong consumer-protection controls. Such ratings, in effect, excuse a lender from supervisory action.

And even where regulators did impose sanctions, measuring such activity proves challenging. Fines and penalties for consumer-protection violations are generally not publicized. Typically institutions agree to work with regulators to address serious compliance problems without triggering negative publicity.

Given such statistics and the largely confidential nature of enforcement proceedings, it is no surprise that many policy-makers and consumer advocates describe an industry that had become complacent (and possibly even a bit arrogant) about compliance.

The coming compliance crunch

But widespread defaults change everything. And therein lies the problem for mortgage institutions, and an opportunity for plaintiffs' attorneys.

An April 2008 study by Navigant Consulting Inc., Chicago, *First Quarter 2008 Update: Reaching New Heights,* found that in the 15 months through March 2008, a total of 448 lawsuits had been filed related to the mortgage crisis—that compared with 559 lawsuits related to the savings-and-loan (S&L) debacle in the 1980s and 1990s.

Borrower class actions represent the largest category (46 percent) of the pending lawsuits cited in the Navigant study. "Like the credit crunch itself, the litigation is unrelenting," says Jeff Nielsen, managing director of Navigant Consulting.

In the first quarter of 2008, "we are looking at approximately two filings per day, including weekends. What we saw in 2007 was a mild breaking wave compared to the tsunami we are witnessing now," Nielsen says.

One of the most frequent claims brought is for Truth in Lending Act (TILA) violations. In the first quarter, 73 percent of borrower class actions filed in federal court include TILA counts, according to the Navigant study. However, the number of plaintiffs and extent of damages may soon skyrocket. The 7th U.S. Circuit Court of Appeals is nearing a decision on a class-action case involving Chevy Chase Bank, Chevy Chase, Maryland (*Andrews v. Chevy Chase Bank FSB* [January 2007]), that could for the first time allow borrowers to rescind (effectively cancel) their loans *en masse* for technical TILA violations.

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Civil actions are not the only hazard, as lenders now find themselves in the consumer-protection crosshairs of at least seven attorneys general, a couple of municipalities and the Federal Bureau of Investigation (FBI).

Amid all of this is a debate about whether regulators' ideas about "safety and soundness" have given inadequate weight to, or were even at odds with, consumer-protection compliance. Comptroller of the Currency John Dugan recently warned his agency's compliance examiners against placing undue emphasis on credit-quality "issues only to find that we've allowed significant compliance problems to develop in their place." Other regulators are ratcheting up their rhetoric and signaling more rigorous compliance supervision.

The cost of all this will be steep. But it reveals symptoms more than causes.

A hangover from the last party

The causes stem in considerable part from regulatory changes arising from the last mortgage crisis.

The period leading up to the S&L debacle was a far simpler one for the mortgage industry. Lenders generally operated in a regional geographic footprint and offered a narrow product menu. The secondary market consisted largely of recourse swaps with government-sponsored enterprises (GSEs) to create and sell securities.

Investors relied on sellers' balance sheets rather than on the quality of the underlying loans. This was because existing regulatory and accounting rules allowed lenders to treat these transactions as a sale, even though the purchaser had

recourse to the seller for credit losses. Sellers, already on the hook for credit losses, favored making representations and warranties (or promises to repurchase the loan) for other risks—such as compliance and fraud—over the costs of due diligence.

Consequently, seller representations and warranties in loan purchase agreements were drafted in the broadest possible terms, including a warranty that the loan was compliant with all applicable laws. This was appropriate, as consumer-protection regulation was considered relatively benign at the time. The Home Ownership and Equity Protection Act (HOEPA) had not yet been enacted; neither were there any anti-predatory-lending laws. Furthermore, the legal costs associated with performing due diligence on loans were prohibitive.

The savings-and-loan crisis forced several changes. Lawmakers sought to relieve the asset-liability mismatch crushing thrifts by almost totally deregulating the industry—phasing out interest-rate ceilings and allowing adjustable-rate mortgages (ARMs) and other alternative mortgage products. This opened the door for loan products and features that are now under intense scrutiny.

In the crisis' aftermath, both prohibitions on interstate banking and the walls separating investment banks from depositories began eroding. This encouraged the rise of nationwide, multi-channel lenders.

Further, new regulatory and accounting rules forced changes in how the industry accounted for secondary market transactions by requiring that all recourse obligations be treated as "on-balance-sheet" financing transactions, not sales. The industry responded by taking advantage of the recently passed real estate mortgage investment conduit (REMIC) legislation, which enabled it to replace recourse swaps by issuing modern mortgage-backed securities (MBS). This gave rise to a robust real estate capital market, with a growing share of it captured by private-label (or non-GSE) issuers.

Because secondary market transactions were now non-recourse, investors shifted their focus from the creditworthiness of the seller to the quality of the underlying loans. This spurred the development of sophisticated technologies, tools and processes to assess loan quality—particularly borrowers' creditworthiness and collateral valuations.

All these factors—deregulation, financial engineering, high technology—help explain how lenders were able to offer new products to borrowers across the credit spectrum, generating revenues while ostensibly retaining little of the risk exposure.

In come the regulators

Consumer advocates complained that the new market required consumer-protection safeguards in order to work, but for a long time few were forthcoming. And so consumer-protection compliance remained a fairly minor risk for all industry participants.

Compliance programs comprised an age-old mix of "front-end" (or pre-closing) training and education, document standardization and simple controls built into loan production systems. This was combined with a more thorough "back-end" quality-assurance function, which was sampling-based, manually intensive, subject to interpretive bias and performed on a post-closing basis.

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The problem with these back-end processes is that they did not eliminate compliance violations; more accurately, they identified and estimated front-end exposure. In other words, they measured contingent liabilities rather than prevented regulatory violations.

In the secondary market, investors reduced their manual due diligence by leveraging automated tools that more accurately and economically assessed credit, collateral and interest-rate risks. But the perceived risks and costs associated with compliance made it more sensible to continue to rely on sellers' representations and warranties.

This approach to compliance was adequate for the time. But eventually, alongside sweeping market evolution came significant changes on the consumer-protection front.

Originators were soon subject to a rapidly growing patchwork of federal and state laws regulating such things as fees and escrows, interest-rate accruals and amortization, and (perhaps most notably) predatory lending. In several states, shorthanded regulators made mortgage investors (including securitization trusts) liable for mistakes made by the originator, effectively turning the secondary market into a *de facto* police force. Where such assignee liability was not express, it was increasingly implied through the examination process.

The now-heightened risk encouraged the creation of more sophisticated tools. The most advanced of these tools were automated compliance engines, decisioning systems similar to automated underwriting engines, which rapidly review loan data for compliance with applicable laws.

Compliance engines enabled a profound design change in lenders' compliance programs. By building them into a loan origination system (LOS) and reorganizing other compliance functions around this primary control, lenders could cost-effectively review all loans against applicable laws prior to funding or purchase without slowing business. In other words,

by enhancing front-end controls, lenders could mitigate more risk and substantially reduce back-end costs.

Budget blues

However, many lenders failed to understand or appreciate the need to redesign compliance programs by means of more-sophisticated automation. A big problem with bad compliance programs is that they don't provide management with an accurate sizing of risk. Managers cannot always focus on fundamentally altering how tasks are performed. Instead, they often seek short-term results (such as driving immediate revenues and profits), basing decisions on the information available and sometimes sacrificing longer-term efficiencies if the perceived needs are not urgent or compelling.

This may explain why instead of improving compliance programs by implementing better front-end tools, many lenders inserted compliance engines into their existing back-end processes—i.e., manually inputting a sample of closed loans. Of course, manual input is costly, slow and subject to interpretive bias. But this approach required minimal information technology (IT) resources, and often allowed more experienced quality-assurance personnel to be replaced by less-skilled labor.

The long-term strategy of many lenders may have involved front-end integrations of automated compliance tools into LOSes. But for the time, such projects were either subsumed by larger initiatives that stalled, or repeatedly pushed behind revenue-generating projects or simply postponed to reduce near-term costs. Lenders instead settled for modifications to their legacy systems and other quick fixes to their front-end controls.

Over the long run, these decisions compound the problem, morphing compliance programs into a thinly stitched mishmash of ineffective systems and duplicative functions. Often these "solutions" depend on manual workarounds requiring increased staffing and significant reliance on "tribal knowledge." It is not uncommon to find redundant personnel inputting identical data into separate systems because they are testing for different things or fall under different profit and loss statements (P&Ls).

The secondary market faces these problems and one more. Investors do not obtain from sellers the data required to perform automated reviews. Therefore, they continue to place much emphasis on sellers' representations and warranties, which, critics argue, has turned out to be only marginally more effective than crossing one's fingers.

It is no surprise, then, that the industry's consumer-protection record is currently so dismal, even as compliance-program costs continue to spiral out of control.

A hot topic gets hotter

The regulatory pressures on lenders are about to become more intense. In July, the Federal Reserve issued final rules effecting changes to Regulation Z. The Fed has clearly interpreted much criticism for lax regulation as an argument for boldness—the new rules can be seen as its vow to fix the consumer-protection problem.

The Fed's rules are anything but modest, and their implications are going to be far-reaching. Past tolerance for reasonable exception rates will no longer be acceptable. Good intentions and costly compliance programs may yet clear a lender's conscience, but almost certainly it will not be enough to excuse noncompliance.

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The Fed's new rules, and similarly trending state regulations, create a new category of "higher-priced mortgage loans" and impose certain protections on those types of loans. Higher-priced mortgage loans are defined by separate calculations and lower thresholds in the new Fed rules than HOEPA loans. These thresholds will capture not only the subprime market, but also a portion of the broader mortgage market.

Among other things, the rules prohibit lenders from making higher-priced mortgage loans without regard to a borrower's ability to repay from sources other than the collateral itself. Unlike general discriminatory or deceptive lending laws, a borrower can show that a lender has violated this prohibition without needing to demonstrate that the violation is part of a "pattern or practice."

The Fed's new rules parallel a growing trend in state anti-predatory lending and lower threshold—so-called rate spread—laws to regulate product selection and underwriting by imposing borrower's interest or tangible net benefit requirements on mortgage lenders. These requirements are subjective, and the guidance for what is required is unclear.

Credit decisions and consumer-protection compliance have always shared some relation. But now these risks are becoming interconnected to an unprecedented degree, and no lender can ignore one without provoking the other.

Fed Chairman Ben Bernanke, during the Fed's July 7 meeting announcing the new regulations, cautioned: "It's a very, very complex undertaking to change these rules."

Indeed, implementing the rules will require mortgage institutions to make significant and complex enhancements to their compliance controls. Going forward, the rules will require substantial systems maintenance, as the market and

interrelated regulatory requirements evolve.

The Fed's new rules don't go into effect until October 2009—a nod to the effort implementation requires. However, this will prove an aggressive timeline for institutions that are already behind the curve.

The swinging pendulum: Get on or get whacked

While most senior executives embrace the importance of compliance, or at least dedicate increasing amounts of time to it, few have the time and know-how to make sure their compliance programs are heading in the right direction. Ultimately, implementing a smarter compliance program hinges on three fundamental factors:

■ *Top-down sponsorship to create urgency, momentum and discipline.*

Deploying compliance engines and eliminating more manual tasks require changes to underlying cost drivers, processes and personnel. Cultural and decision-making realities in most large institutions make these changes unlikely without a clear mandate from leadership.

■ *Front-end deployment of a robust compliance engine.*

For originators, this means integrating a compliance engine into the production platform and reviewing all loans prior to funding. The engine should be maintained separately from the loan origination and document production systems in order to ensure appropriate checks and avoid unidentified glitches from production-related enhancements.

For secondary market investors, this means distributing compliance engines more assertively to ensure sellers are funding loans the investor can buy. Investors should check larger sellers' internal controls by regularly running a batch of loans through the investor's compliance engine.

For smaller sellers, investors should make their compliance engines available and provide incentives to encourage use. Providing such incentives through modified representations and warranties may be a smart approach for investors to take. Arguably, if a seller submits a loan to an investor's compliance engine, the investor should not have to look beyond whether the data submitted to the engine match the delivered loan. This cost-free strategy would improve seller relationships and loan quality simultaneously.

■ *A realistic understanding of costs.*

Developing and—trickier—maintaining a compliance engine that accurately manages (and does not accidentally introduce) regulatory risk in a manner consistent with business goals requires knowledge, experience and commitment.

By far the largest cost driver in maintaining a compliance engine is personnel costs. It requires compliance and IT subject-matter experts with cross-disciplinary knowledge. These resources must be dedicated full-time to maintaining the compliance engine, because regulation can change suddenly—due to emergency legislation, regulator opinions and court decisions—and can have unintended consequences.

It is a challenge for lenders to marshal all the moving parts needed to keep compliance engines current with ongoing regulatory change. And it is expensive to dedicate skilled resources that could otherwise be devoted to growth initiatives. For this reason, some lenders rely on external experts who provide compliance engines on a variable-cost basis.

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But here there are challenges, too. Regulation has become so complex and fast-changing that many vendors lack the resources required to maintain robust compliance engines. Clearly, a shoddy solution can introduce more risks than it mitigates. Among the many things to think about, three are most critical.

Expertise: Consider only solutions that are maintained by experts and diligently monitored by nationally recognized outside counsel. A compliance engine should replicate the consensus decision-making pattern of a team of experienced specialists.

Precision: Make certain the solution supports a broad product menu and is customizable for a lender's license or charter authority, regulatory elections and internal compliance policies. One-size-fits-all solutions lack accuracy. In addition to missing violations, they can fail loans that actually comply. Keep in mind that an institution is, above all, what its risk-management controls enable it to be.

Reporting: The solution should provide management with helpful information on which to base its decisions.

Current economic realities have lenders focused on cost management. Business leaders, however, must send the right message. The difference between cost-cutting and spending wisely must be discerned, or else managers will focus excessively on the short-term performance of the business while neglecting longer-term issues and opportunities.

Prudent expenditures on smarter compliance management will help lenders regain the trust of customers, safeguard their institutions, cut long-term costs and realize sustainable growth. **MB**

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